Decision **PROPOSED DECISION OF ALJ GALVIN (Mailed 6/21/2005)**

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Investigation into the Revenue Requirement of SureWest Telephone Company Pursuant to Decision 00-11-039. (U 1015 C)	Investigation 01-04-026 (Filed April 19, 2001)

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Laura J. Tudisco, Attorney at Law, for the Office of Ratepayer Advocates.

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OPINION AUTHORIZING SUREWEST TO CONTINUE RECEIVING CALIFORNIA HIGH COST FUND-B FUNDING ON AN INTERIM BASIS

I. Summary

This decision authorizes Roseville Telephone Company (SureWest)[1] to continue receiving an annual $11.5 million California High Cost Fund (CHCF) payment to offset its intrastate regulated operating expenses on an interim basis. This decision requires SureWest to prepare a cost proxy model (CPM) based on its current cost data. The results of this study and resulting impact on its rates, on the Universal Lifeline Telephone Service (ULTS) fund, and on the CHCF-B fund shall be filed by SureWest as an application for authority to modify the CPM for SureWest within 12 months after the effective date of this decision. SureWest shall serve an electronic mail notice of its application to all certificated telecommunications carriers.

SureWest is also authorized to file an advice letter with the Commission's Telecommunications Division to incorporate its rate design proposal of applying its CHCF-B draw from the period March 2001 through February 2002 as a reduction to its business access line rates. The advice letter filing shall become effective when authorized, but not less than five days after filing.

II. Procedural History

In August 1999, SureWest filed Application (A.) 99-08-043 seeking authority to replace its $11.5 million annual settlement arrangement with Pacific Bell Telephone Company (Pacific), subsequently doing business as SBC California, with either the California High Cost Fund- A (CHCF-A) or the

California High Cost Fund- B (CHCF-B).[2] That application was filed pursuant to the terms of SureWest and Pacific's joint settlement agreement that provided for Pacific to pay SureWest $11.5 million per year for replacement of prior settlement arrangements. The $11.5 million annual payments to SureWest were used by SureWest to recover a portion of its total regulated operating expenses

In Decision (D.) 00-11-039, the Commission authorized Pacific to discontinue paying the $11.5 million annual payment to SureWest. This action resulted in an $11.5 million revenue increase to Pacific and an $11.5 million revenue shortfall to SureWest. Although no further action was taken toward Pacific as a result of its increased revenue, SureWest was authorized to replace the funding of that payment from the CHCF-B on a temporarily basis. At that time, the Commission concluded that it was not appropriate to use either the CHCF-A or CHCF-B as a permanent source of funding for the $11.5 million.

The then assigned Administrative Law Judge (ALJ) prepared an Order Instituting Investigation (OII) to review SureWest's revenue requirement for the purpose of determining whether recovery of the $11.5 million should come from SureWest's shareholders, ratepayers in the form of rate increases, or a combination of the two.

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[1] SureWest Telephone Company changed its name to SureWest Telephone pursuant to Advice Letter No. 839 dated September 9, 2003.

[2] The CHCF-A was established as a means of keeping reasonable and affordable basic exchange rates for customers of smaller Local Exchange Companies that concurred in Pacific's statewide average toll, private line, and access rates, pursuant to D.85-06-115. The CHCF-B was established to provide subsidies to carriers of last resort for providing affordable basic local telephone service in high-cost areas, pursuant to D.96-10-066.

On April 20, 2001, the Commission issued this investigation into SureWest's Revenue Requirement to determine the appropriate source of permanent funding to replace the $11.5 million payment. As directed by the investigation, SureWest submitted a September 17, 2001 compliance filing that included a balance sheet and income statement, cost support for services for which SureWest proposed price changes, and other specified data relating to operating revenues, expenses, rate base and rate design. In that Compliance Filing, SureWest proposed that the $11.5 million annual funding be recovered from the CHCF-B on a permanent basis.[3] On June 28, 2002, SureWest and Office of Ratepayer Advocates (ORA) submitted Opening Testimony and on October 4, 2002, Rebuttal Testimony. Evidentiary hearings began November 4, 2002 and continued through November 7, 2002. This investigation was submitted on the filing date for Reply Briefs, January 31, 2003.

III. Joint Comparison Exhibit

This case was reopened by the then assigned ALJ to receive a joint SureWest and ORA test year 2002 results of operations comparison exhibit. This case was resubmitted upon receipt of that comparison exhibit on February 19, 2003. This joint comparison exhibit is being used in this proceeding as a basis to determine whether SureWest is able to receive a reasonable return on its investment without the need for continued funding of the $11.5 million and, if a continued need exists, where that funding should come from.

The joint comparison exhibit shows a total company test year 2002 difference of $31 million in net operating income and $72 million in rate base between SureWest and ORA. On an intrastate basis, used for California

[3] September 17, 2001 Compliance Filing, p. 2.

ratemaking and EAS revenue recovery needs, this equates to approximately a 2.57% return on rate base under SureWest's test year estimates and a 26.54% return on rate base under ORA's test year estimates.[4]

SureWest is authorized a 10.00% benchmark return on intrastate rate base under its current NRF sharing arrangement. Because the return on rate base under the test year estimates of SureWest is substantially below its authorized benchmark rate of return, it would be necessary to determine an appropriate source to continue funding the $11.5 million. Conversely, since the return on rate base under the test year estimates of ORA is substantially above SureWest's authorized benchmark rate of return, there would be no need to do so.

Undisputed test year estimates included operating revenue from local and long distance network services and rate base components of materials and supplies and working cash. These undisputed estimates resulted from a review of initial positions, correction of errors, a better understanding of the other party's estimates, and availability of more recent data to ORA after SureWest responded to this investigation.

Upon careful analysis of the record and consideration of reasons for the parties' estimates, we find that the undisputed estimates set forth in the joint comparison exhibit excluding working cash, which is discussed in a subsequent section of this order, are reasonable, consistent with law, and in the public interest.

There are twenty-seven issues upon which the parties could not agree, resulting in a total company difference of $31 million in net operating revenue

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[4] Exhibit 41, p. 1-11.

and $72 million in rate base.[5] These issues are summarized by major category in the following tabulation and discussed in the remainder of this decision under the categories of operating revenue, operating expense, and operating taxes.

CATEGORY (a)	SUREWEST (b)	ORA (c)	DIFFERENCE (b-c)
Operating Revenue	$121,188,000	$123,709,000	$(2,521,000)
Operating Expense	102,153.000	54,161,000	47,992,000
Operating Taxes	9,384,000	28,775,000	(19,427,000)
Net Operating Revenue[6]	9,687,000	40,773,000	(31,086,000)
Rate Base	210,863,000	139,068,000	71,795,000

IV. Operating Revenue

The $2,521,000 operating revenue difference between SureWest and ORA consisted of $1,671,000 in miscellaneous revenue and $850,000 in uncollectibles.

A. Miscellaneous Revenue

The $1,671,000 miscellaneous revenue difference resulted from ORA imputing rental income for SureWest land and buildings being used by its affiliated companies.

Prior to a January 1, 2002 corporate realignment implemented by SureWest as part of its parent company reorganization plan approved by the Commission in D.96-07-059, SureWest allocated its land and building costs to affiliated companies based on their usage of SureWest's land and buildings. SureWest recorded these usage costs allocated to its affiliated companies as a reduction (credit) to its operating expenses. Subsequent to that realignment, all of SureWest's land and building costs were charged to its parent company and

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5 Henceforth, all numbers are rounded to $1,000.

6 Operating revenue minus operating expense and minus operating taxes.

then allocated to each affiliate, including SureWest, based on usage. The net costs associated with land and buildings used in providing services to SureWest remained on its accounting records as a cost of providing telephone service and resulted in no increased cost to SureWest.

ORA recommended that $1,671,000 of rental income be imputed as miscellaneous revenue to compensate SureWest for the rental of office space transferred to its affiliated company. However, the adoption of ORA's recommendation would result in an unjustified reduction in the expenses of SureWest because the utility would receive benefit from imputed rental income associated with land and buildings not currently being paid or maintained in its telecommunications operations. Should we adopt ORA's adjustment we would need to reallocate land and building investment and costs back to SureWest from its affiliated companies. This would result in increasing its expenses and result in no net adjustment to miscellaneous revenue. The $1,671,000 miscellaneous revenue adjustment recommended by ORA is not adopted.

ORA raised in its brief the issue of whether SureWest followed the affiliate transaction rules for the transfer of assets as set forth in Pub. Util. Code § 851.[7] The provisions of that section requires a public utility, such as SureWest, to obtain Commission authority to sell, lease, assign, mortgage, or otherwise dispose of public utility property.

Testimony in this proceeding addressed SureWest's test year results of operations for the purpose of determining whether SureWest needs a source of permanent funding to replace the $11.5 million funding it receives from the

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[7] All citations are to the Public Utilities Code unless otherwise indicated.

CHCH-B. SureWest neither requested nor addressed the sale or transfer of public utility property. Should SureWest want to actually sell, transfer, or lease public utility property, it will need to file a § 851 application. Approval of an allocation method for this proceeding shall not be construed as authority to transfer any of SureWest's public utility property to any of its affiliates.

B. Uncollectibles

The $850,000 uncollectibles difference between SureWest and ORA was due to SureWest reducing revenue for income it no longer expected to receive in the test year due to the bankruptcy filings by Global Crossings and WorldCom / MCI. SureWest made this adjustment as part of its October 4, 2002 rebuttal testimony.[8]

ORA opposed this revenue reduction on the basis that it was inconsistent with SureWest not adjusting revenue for the effect of the bankruptcy of XO Communications, a major competitive local exchange carrier within SureWest's territory that was larger in size than SureWest and whose intense competition resulted in over-capacity, lower pricing power and loss of asset value for all competitors.[9]

Irrespective of ORA's concern that XO Communications is now bankrupt and that SureWest is not treating the Global Crossing and WorldCom / MCI bankruptcy filings comparably, neither SureWest nor ORA demonstrated whether SureWest's operating revenue was impacted by XO Communications bankruptcy filing.

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[8] Exhibit 34, p. 3.

[9] ORA reply brief, p. 3 and Exhibit 20, p. 8.

Although SureWest reduced "anticipated revenue" attributed to the companies that recently filed for bankruptcy, SureWest did not disclose whether the anticipated revenue was for service already rendered by SureWest or for future service to be rendered by SureWest.[10]

To the extent that all or a portion of the reduced revenue was due to SureWest for past service, such reduction may have been premature because the mere filing for bankruptcy does not automatically forgive the filer from paying its debts. SureWest was silent on whether the bankruptcy court acted on the bankruptcy filings, authorized debt forgiveness or established payment terms for these companies.

To the extent that all or a portion of the reduced revenue was for future service, SureWest was silent on whether Global Crossing and WorldCom/MCI would continue to provide SureWest with its estimated revenue during their respective bankruptcy proceeding or subsequent approval of any bankruptcy. SureWest was also silent on whether the bankruptcy court would or would not provide payment terms or a guarantee of payment for future service from SureWest during the bankruptcy proceeding. Further, SureWest was silent on whether the customers of the companies that filed for bankruptcy could or would switch their telecommunications needs directly to SureWest or interconnect with other competitors that interconnect with SureWest, thereby continuing to provide SureWest with its estimated revenue.

[10] Exhibit 34, p. 3.

SureWest provided insufficient evidence to substantiate the need to increase its test year uncollectibles or to substantiate whether such an instance would reasonably be expected to reoccur on a yearly basis. SureWest's $850,000 uncollectibles adjustment is not adopted.

V. Operating Expense

The $47,992,000 test year operating expense difference between SureWest and ORA is in nine categories, as shown in the following tabulation.

ITEM	DIFFERENCE
Escalation of Expenses	$ 4,666,000
Rate Case	1,001,000
Access Cost & Directory Assistance	431,000
Local Competition	587,000
Energy, Insurance & Pension	1,785,000
Early Retirement	375,000
Corporate Operations	12,486,000
15% Expense Elimination	9,007,000
Depreciation	17,654,000
TOTAL	**$47,992,000**

A. Escalation of Expense

The $4,666,000 escalation of expenses difference between SureWest and ORA resulted from a disagreement of the test year expense escalation for six expense components. These components are discussed below and summarized in the following tabulation.

ITEM	DIFFERENCE
Growth & Output Factor	$ 66,000
Inflation Factor	713,000
Reciprocal Compensation	728,000
Directory Publishing	938,000
Miscellaneous Items	215,000
Prior Adopted Adjustments	2,006,000
TOTAL	**$4,666,000**

1. Growth & Output Factor

The Growth and Output Factor represented a composite of access line growth and the usage output from those access lines. SureWest developed composite factors of historical growth in switched access lines, special access services, and switched access minutes of use (MOU) for its 2000 and 2001 base years and escalated these factors for test year expenses.

An error in SureWest's test year growth and output factor was discovered by SureWest and ORA during the course of an ORA onsite review of SureWest's initial filing made on September 17, 2001. SureWest's composite growth and output factor spread sheet using June 2001 annualized revenues incorrectly totaled 109.40% instead of 100.0%. That error resulted in SureWest using the 109.40% to calculate a 2000 output escalation factor of 4.22% to project 2001 expenses and a 2001 output escalation factor of 4.59% to project 2002 test year expenses.

On January 30, 2002, SureWest provided ORA with a corrected test year growth and output factor. This changed the 2000 output escalation factor to 3.87% from 4.22% and 2001 factor to 4.41% from 4.59%. Subsequently, in May 2002, SureWest updated its growth and output factor to 4.00% from 3.87%, based on twelve months recorded experience ending December 2001.

The $66,000 growth and output factor difference occurred because ORA used SureWest's 3.87% corrected growth and output factor over SureWest's updated 4.0% factor. ORA rejected SureWest's May 2002 updated growth and output factor on the basis that ORA did not audit the new factor.

Although ORA did not have an opportunity to audit SureWest's updated growth and output factor, SureWest did correct and ORA did use SureWest's corrected method in calculating the test year growth and output factor. There is nothing in the record to indicate that SureWest's updated growth and output factor was miscalculated. The only difference between SureWest and ORA's factor is the use of more recent information by SureWest.

The inclusion of more recent information to project test year expenses more accurately reflects reality and should be used in this instance. We will take the same approach in determining a reasonable inflation factor to be used in this proceeding, as discussed below. ORA's $66,000 adjustment to the growth and output factor is not adopted.

2. Inflation Factor

The $713,000 inflation factor difference between SureWest and ORA was due to the use of different methodology in determining a test year inflation rate.

SureWest based its inflation factor on the 1998 through 2001 Consumer Price Index (CPI) for all urban consumers as reported on the U.S. Department of Labor Bureau of Labor, as printed on August 16, 2002. That report showed that the CPI increased 2.20% in 1999 over 1998, 3.40% in 2000 over 1999, and 2.80% in 2001 over 2000. SureWest applied a simple average of the two prior years' inflation rates (2.80% plus 3.40% divided by two) to arrive at a test year inflation rate of 3.10%.

ORA also used the 2.80% and 3.40% CPI factors. However, ORA rejected the use of a simple average of the two inflation factors in favor of the April 2002 published seasonally adjusted annual rate for all urban consumers of 1.90%.

SureWest contends that ORA's CPI factor should be rejected on the basis that its approach contradicts the methodology ORA used for all other factors in this proceeding and contradicts the methodology used by the Division of Ratepayer Advocates (ORA's predecessor) and adopted by the Commission in D.96-12-074 (implementation of a new regulatory framework for SureWest)

Under SureWest's method, its 3.10% CPI for the test year is higher than the recently reported 1.90% CPI change for 2002 from 2001 and higher than the 2.80% CPI change for 2001 from 2000. SureWest's simple averaging of CPI changes fails to reflect the downward trend of inflation. ORA's 1.90% test year CPI should be adopted because it reflected the current trend in CPI. The $713,000 inflation factor adjustment recommended by ORA is adopted.

3. Reciprocal Compensation

The obligation to pay reciprocal compensation is a new expense imposed on SureWest by the Commission as a result of interconnection agreements with competitive local exchange carriers. According to SureWest, ORA admitted on cross that reciprocal compensation expense is a cost of doing business.[11] Because this expense is fairly new (the Commission imposed this cost on SureWest in the September 2000 and February 2001 timeframe), and the cost has grown significantly since its inception, the recorded historical periods (1999 and 2000) did not reflect an accurate view of current or future expense obligations associated with reciprocal compensation. Accordingly, SureWest asserts that the use of unadjusted historical amounts in the averaging methodology would severely understate actual expenses currently incurred.

ORA recommended that all cost increases SureWest proposes for reciprocal compensation should be excluded from consideration in this case. It takes this position on the basis that SureWest is a NRF company now; reciprocal compensation is one of SureWest's costs of doing business as a NRF company and should not be a consideration in this proceeding. SureWest rebuts ORA's statements, saying that the suggestion that SureWest's revenue requirement should not include expenses associated with the offering of "competitive services" would virtually eliminate every expense that SureWest incurs.

ORA recommended that if reciprocal compensation expense is included in the calculation of SureWest's revenue requirement, normalizing adjustments should not occur and that the expense level should be limited to $64,000. This amount was provided to ORA by SureWest as the cost actually incurred in 2000 pursuant to Interconnection Agreements (ICAs).[12]

Reciprocal compensation is a new expense properly includable in SureWest's revenue requirements as a cost of doing business. The $64,000 figure ORA cited is meaningless in this instance since it represents only new expenses for 2000 and does not reflect normalization of three months expenses for the Pac-West ICA and two months expenses for the ELI ICA. It is appropriate to make a normalized adjustment in the case of reciprocal compensation expenses, which resulted from ICAs with Pac-West, which became effective on September 7, 2000 and ELI on October 23, 2000. The $728,000 reciprocal adjustment recommended by ORA is not adopted.

4. Directory Publishing

SureWest entered into a new directory publishing agreement with its affiliate, SureWest Directories, in 2001 that requires SureWest to pay for the printing and distribution costs of the SureWest directory. SureWest normalized this new cost by adjusting its 1999, 2000 and 2001 directory expenses before applying its escalation, growth and output, and productivity factors to arrive at its test year directory expense.

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[11] Reporter's Transcript, Vol. 4, p. 248.

[12] Exhibit 41, p.3-9 and 3-10.

According to ORA, SureWest's estimated costs associated with its affiliated directory publishing and distribution agreement was not identified as an adjustment in its September 17, 2001 filing. When ORA brought this adjustment to SureWest's attention, ORA was informed that this adjustment was included after all the workpapers had been completed and was only added later to the spreadsheets in the workpapers that contained the escalation calculations for 1999 through test year 2002 operating expenses. Although SureWest provided ORA with a copy of its new publishing agreement, ORA asserted that SureWest did not provide ORA with the source data that SureWest relied upon to normalize its Directory Publishing costs. ORA does not take issue with SureWest's escalation methodology.

SureWest clarified that its new directory publishing agreement was executed only days before its September 17, 2001 deadline for its results of operations compliance filing. Although SureWest did not update the narrative portion of its filing to reflect the directory adjustment support for this adjustment the adjustment was included in its workpaper binder 5 of 7, tab 14.8. SureWest also clarified that the adjustment was discussed with ORA during ORA's on-site visits and on a March 22, 2002 conference call.[13]

SureWest has substantiated that this adjustment was disclosed in its workpapers and that ORA did not take issue with SureWest's escalation methodology. The $938,000 directory expense adjustment is not adopted.

With this shifting of responsibility for the printing and distribution of SureWest's directory to SureWest from its affiliate we were surprised to find

[13] Exhibit 35, p. 9.

nothing in the record regarding a proportionate change in the sharing of directory revenue between these entities. SureWest shall fully address how the directory revenue is being shared with its affiliate in its next NRF proceeding.

5. Miscellaneous Items

The $215,000 miscellaneous items difference between SureWest and ORA consisted of minute cost differences related to SureWest's name change, corporate realignment, shareholder relations, travel, meals, entertainment, membership and dues, network security, legal costs and various errors and omissions. A detailed comparison of the recommended disallowances by individual components of the miscellaneous items is not set forth in this order because the individual amounts identified in testimony and briefs do not comport to the amount identified in the comparison exhibit.

One component of the minute difference pertained to Shareholder Relations activity in 2001. The ORA recommended a $27,764 adjustment that consisted of a $2,764 adjustment in actual cost incurred for moving Shareholders Relations activities to an outside vendor from SureWest and $25,000 per year for the cost of mailing annual shareholder reports.

ORA recommended a disallowance of miscellaneous items on the basis that the costs were excessive and that SureWest failed to demonstrate any ratepayer benefit from the miscellaneous items.[14]

Contrary to ORA's recommendation, shareholder relations activities, including the mailing of annual shareholder reports, is a necessary business activity to maintain its credit ratings and ability to obtain necessary capital and

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[14] *See* for example, Exhibit 41, p. 3-11, 3-17 and 3-18.

debt for providing telecommunications services.[15] The $215,000 miscellaneous items disallowance recommended by ORA is not material and not adopted.

6. Prior Adopted Adjustments

The $2,006,000 operating expense difference between SureWest and ORA is in the treatment of accounting adjustments mandated by D.01-06-077,[16] dated June 28, 2001.

SureWest adjusted its recorded 1999, 2000, and 2001 base years with the adjustments specified in D.01-06-077 prior to developing test year 2002 operating expense estimates. ORA also used the recorded 1999, 2000, and 2001 years of SureWest as a base to develop test year 2002 operating expense estimates. However, the recorded 1999 and 2000 amounts used by ORA excluded the adjustments specified in D.01-06-077 and the recorded 2001 amounts used by ORA included the adjustments specified in D.01-06-007 twice because ORA applied the specified adjustments to SureWest's 2001 actual operating expenses that already included those adjustments.[17]

ORA concluded from its review of SureWest's supporting workpapers and field work it performed for the current audit that SureWest had, for the most part, complied with the treatment of the NRF audit adjustments required by D.01-06-077.[18] Subsequently, ORA clarified that SureWest had complied with all the adjustments specified in that decision and had made the

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[15] *Id.,* p. 16 and p. 17.

[16] SureWest's first triennial NRF review.

[17] *See* footnotes 2 and 3 of RTC and ORA's February 19, 2003 Joint Comparison Exhibit.

[18] Exhibit 41, p. 2-1.

required adjustments to its 1999, 2000, and 2001 base years used to derive test year 2002 estimates.[19]

With ORA's acknowledgment that SureWest complied with the adjustments required by D.00-06-077 and ORA exclusion of those adjustments in its 1999, and 2000 base years and double counting of such adjustments in its 2001 base year, ORA's prior adopted adjustments totaling $2,006,000 in test year 2002 is not adopted.

B. Rate Case

SureWest made a $1,001,000 test year expense adjustment to recover the costs associated with this revenue requirement proceeding. SureWest based its estimate on a three year amortization period, the same amortization period approved by the Commission in SureWest's last general rate case proceeding.

ORA asserted that SureWest is now covered under the New Regulatory Framework (NRF); it no longer incurs rate case expenses. According to ORA, SureWest is compensated for regulatory expenses by means of the shareable earnings calculations.

While SureWest is a NRF company, it is participating in this proceeding at the Commission's request. The Commission has routinely allowed utilities to recover the costs of participating in a rate case proceeding, and this case is similar to a rate case proceeding. However, we are disturbed at the idea of including this in expenses since it is a one-time event. There will be no future "rate cases" for this NRF Company, and SureWest should not be allowed to include this figure in its ratebase on an ongoing basis. Therefore, the $1,001,000

[19] Reporter's Transcript Vol. 4, p. 235 and p. 236.

rate case expense is not adopted. Instead, SureWest may apply for recovery of this expense as an exogenous factor.

C. Access Cost and Directory Assistance

SureWest increased its 2002 test year expenses by $431,000, of which $349,000 pertained to access cost and $82,000 to directory assistance. These adjustments were made by SureWest to reflect the impact of its cost associated with the termination of the Designated Carrier Plan (DCP) between Pacific and SureWest.[20]

As a result of the termination of the DCP, SureWest now provides regulated intraLATA toll services directly to its customers and directory assistance service for calls generated by customers dialing 555-1212. These calls were previously handled by Pacific's directory operators. SureWest is now required to pay Pacific terminating access for all intraLATA toll calls that it delivers to Pacific and bear the additional cost of providing the directory assistance service, which SureWest previously did not have to pay or incur under the DCP. Hence, SureWest adjusted its test year 2002 operations to reflect the termination of the DCP with Pacific and cost of providing directory assistance for its customers.

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[20] Under the DCP, SureWest selected Pacific to be its designated intraLATA toll carrier. For originating traffic, SureWest billed its end-user customers at Pacific's intraLATA toll tariff rates and remitted those revenues to Pacific. SureWest would then bill Pacific for the originating access traffic under SureWest's originating access tariffs. SureWest also performed billing and collection and operator service functions for Pacific on these calls, and billed Pacific billing and collect and operator service charges. For traffic terminating in SureWest's territory, SureWest billed Pacific terminating access charges under SureWest's access tariffs. This compensation arrangement functioned similar to the arrangement under which SureWest provides services to interexchange carriers.

According to SureWest, ORA erroneously characterized the access charges paid to Pacific for the provision of intraLATA toll service as competitive losses. SureWest asserted that even though intraLATA toll is a competitive service it should not preclude SureWest from recovering its costs of providing intraLATA toll service as part of its revenue requirement. SureWest further stated that ORA's proposal to disallow costs associated with the provision of intraLATA toll lacks internal consistency.

SureWest included in its test year results of operations $1,468,000 in switched access revenue for calls originating from Pacific exchanges that terminate in SureWest's exchange. The test year results of operations also included $2,262,000 in intraLATA toll revenue that SureWest would collect from customers for providing intraLATA toll service. Revenue associated with directory assistance was also reflected in SureWest's test year operating revenue.[21]

Although ORA recommended disallowing the costs associated with intraLATA toll and directory assistance it did not propose to exclude the revenue SureWest would receive from this shift of service to SureWest from Pacific. The failure to match revenue with costs, as ORA has recommended, distorts SureWest's revenue requirement. SureWest has handled this issue appropriately, taking both revenue and expenses associated with provision of intraLATA toll and directory assistance services into account. The $431,000 access cost and directory assistance adjustment recommended by ORA is not adopted.

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21 Exhibit 34, p. 18.

D. Local Competition

SureWest included $587,000 of local compensation implementation cost in its test year expenses. This local compensation cost was based on a three year amortization of all costs SureWest incurred for the period 1997 through July 31, 2001, including direct charges incurred for legal and consultant fees as well as SureWest employees' time charged for labor and overhead.

According to ORA, the Commission extended the coverage of the rules adopted for local exchange competition in the service territories of Pacific Bell and GTEC (now Verizon) to apply to SureWest and Citizens (D.97-09-115) in 1997. That decision authorized SureWest to establish a memorandum account and accrue therein actual implementation costs for local exchange competition prospectively.[22] The rules adopted for the local exchange companies also required reports on incurred implementation costs be filed and addressed in the Local Exchange Competition docket, R.95-04-043/I.95-04-044.

ORA recommended that SureWest should file a report with the Commission summarizing the amount and nature of its implementation costs from September 24, 1997 to the present. ORA also recommended that SureWest should file its report in the Local Competition docket so that potential competitors have notice and an opportunity to review the recorded implementation costs and be heard on the issue. ORA concluded that local competition implementation costs should not be considered in this proceeding for purposes of assessing SureWest's financial need for the annual EAS funding of $11.5 million.

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[22] 75 CPUC 2d, 722 at 734 (1997).

ORA is the only party to this proceeding, and we need to address this issue in a forum where SureWest's competitors have an opportunity to be heard; the appropriate forum is our local competition proceeding. Accordingly, we concur with ORA's position that local competition implementation costs should not be considered in this proceeding. SureWest may seek recovery of its local competition implementation costs in a separate application with notices of the application to interested parties of the Local Exchange Competition docket. The $587,000 of Local Competition costs included in SureWest's test year operations is not adopted.

E. Energy, Insurance & Pension

There was a $1,785,000 energy, insurance and pension expense difference ($310,000 in energy, $105,000 in insurance, and $1,370,000 in pension) between SureWest and ORA.

SureWest increased test year expenses by $310,000 to reflect growth in SureWest's energy cost associated with increased electric and gas prices. One of its electrical providers, SureWest Electric, received approval for an overall 15% increase in rates. That increase was implemented in two segments: 7.5% in 2001 and an additional 7.5% in 2002. In addition, PG&E increased electric and gas prices in 2001.

Also, in its May 17, 2002 filing, SureWest increased its test year insurance expense by $105,000 due to the tragic events of September 11th and increased its pension expenses by $1,370,000 because "investment returns in

SureWest's Pension Plan have been negatively impacted by the current economy."[23]

ORA asserted that none of these cost increases were specific to SureWest; other companies, not just telephone utilities, are similarly affected. According to ORA, the NRF mechanism allows NRF companies like SureWest to seek a rate increase for costs associated with exogenous events by means of an application or by the annual price cap filing. SureWest has not filed an application for recovery of its increased energy and insurance costs and does not intend to.[24]

ORA pointed out that the Commission's analysis of NRF companies seeking exogenous factor treatment must satisfy nine criteria.[25] Among those criteria are whether the cost a normal cost of doing business even if it is increased by an exogenous event and whether the event has a disproportionate impact on the Local Exchange Companies (LECs). ORA concluded that the increases in energy, pension, and insurance costs do not meet the criteria for limited exogenous factor treatment. Accordingly, if those costs were included in the calculation of SureWest's revenue requirement, the Commission would effectively be granting SureWest a rate increase it would not allow any other NRF company.

While this case has many of the aspects of a General Rate Case, we are mindful of the fact that SureWest is a NRF company. It is not our intention here to allow recovery of costs that should be absorbed as a cost of doing business and

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[23] Exhibit 27 and Exhibit 29 p. 13 and p. 14.

[24] Reporter's Transcript Vol. 1, p.89.

[25] 55 CPUC 2d, 1, 36 (D.94-06-011).

which doesn't meet our recovery criteria for NRF companies. The $1,785,000 of increased energy, pension and insurance expense is not adopted.

F. Early Retirement

The $375,000 early retirement expense difference between SureWest and ORA was due to a difference in the treatment of depreciation expense for SureWest's Signal Transfer Point (STP) switches.

SureWest proposed to accelerate the rate of depreciation for its STP switches to 13.5 months from 3.97 years outside of the composite depreciation rate for switches being undertaken as part of the depreciation represcription review in this proceeding.[26] SureWest accelerated the rate of depreciation for its STP switches on the basis that its vendor notified SureWest that it was discontinuing technological support for the switches and that the current STP switches need a significant maintenance upgrade to replace power supplies due to reported failures that could jeopardize customer service.[27]

As shown in the February 19, 2003 comparison exhibit, ORA opposed the early retirement of SureWest's STP switches as a specific item outside of the depreciation represcription review being undertaken in this proceeding.

An early retirement of investments is only one of a multitude of factors (other factors include, but are not limited to, obsolescence, technological changes, and future net salvage value) considered in a depreciation represcription review. With a depreciation represcription review of all SureWest investment accounts

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[26] Depreciation represcription is a process of determining depreciation parameters such as average service life, shape of the survivor curve, average remaining life and future net salvage of each composite plant account for computation of depreciation rates.

[27] Exhibit 27.

being undertaken in this proceeding, it would not be appropriate to consider a stand-alone depreciation adjustment for STP switches. The impact of any early retirement of STP switches should be considered as part of the depreciation represcription review. The $375,000 early retirement expense of STP switches recommended by SureWest is not adopted.

G. Corporate Operations

The $12,486,000 Corporate Operations expense difference between SureWest and ORA was due to a difference in the treatment of test year salaries included in that expense category.

SureWest included salaries of its Corporate Operations employees that were transferred from SureWest to its parent company on January 1, 2002. That transfer involved 187 employees from five business units. The business units were Corporate Finance, Administrative Services, Corporate Marketing, Information Technology Solutions (ITS) and External Relations. SureWest included the salaries of these business units on the basis that the activities performed by these employees would continue to be used by SureWest for its utility operations.[28]

ORA excluded all Corporate Operations test year salaries on the basis that SureWest did not provide ORA with sufficient information for ORA to determine what impact the transfer of its entire Corporate Operations from SureWest to its parent company would have on test year Corporate Operations expense.[29]

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[28] Exhibit 33.

[29] Exhibit 41, p. 3-24 and p. 3-25.

This transfer of corporate employees and business units was undertaken by SureWest as part of its implementation of a parent company reorganization plan approved by the Commission in D.96-07-059. Prior to this transfer of employees and business units within the Corporate Operations of SureWest to SureWest, the costs of those employees and business units were recorded on the books of SureWest and allocated to affiliates through various allocation procedures deemed by SureWest appropriate for that cost. Now, the costs are recorded on the books of SureWest and allocated to the individual subsidiaries, including SureWest, based on the same allocation process used when those business units were a component of SureWest.

The Corporate Finance Department was and continues to be responsible for corporate accounting, treasury, and investor relations of SureWest and its affiliates. The activities of this business unit include general and regulatory accounting, budgeting and forecasting, customer end user and interexchange carrier billing, payment processing, affiliate transaction reporting, internal and external financial reporting, and tax reporting.[30]

The Administrative Service Department was and continues to be responsible for human resources, purchasing administration and distribution services, fleet services, maintenance and administration of property, and safety and risk management including worker compensation claims.[31]

The Corporate Marketing Department was and continues to be responsible for planning and research, marketing communications, and public relations. Since the transfer of this business unit to SureWest's parent company,

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30 Exhibit 37.

this business unit has completed at least forty projects for SureWest which included bill inserts to communicate to its customers, radio, print and outdoor advertising to support promotional campaigns, direct mail, sales collateral for use by the sales force, signage, product literature and updates to the website. This business unit has also performed public relations activities such as news story placement and community involvement projects.[32]

The ITS Department was and continues to be responsible for business process improvements, information technology architecture, new systems development and integration, existing system operations, support, maintenance and enhancement, corporate information infrastructure, and corporate data security for all subsidiaries. Since the transfer of this business unit, ITS has either completed or is working on activities that include automated call distribution contact center system with interactive voice response and quality assurance capabilities, Genesys customer information and billing system, customer service fulfillment process mapping, and web based customer bill presentation.[33]

The External Relations Department was and continues to be responsible for all matters before the Federal Communications Commission (FCC) and California Public Utilities Commission, including the filing of Advice Letters, regulatory comments, mandatory regulatory reports and filings, and responses to regulatory data requests. This business unit also performs functions related to inter-carrier interconnection negotiations, toll and access revenue, revenue requirements, and the preparation and submission of documents and

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[31] Exhibit 38.

[32] Exhibit 39.

[33] Exhibit 40.

information in connection with formal and informal regulatory proceedings. Specifically, this business unit was transferred it has made 72 tariff filings for SureWest since unit was transferred from SureWest to its parent company. Of those 72 tariff filings, 64 were filed with this Commission and eight with the FCC.[34]

To the extent that the transferred operations resulted in a shift of work activities from SureWest to its affiliates and non-regulated operations then a disallowance of those salaries are justified. However, as detailed above, the activities performed by each of the transferred business units continue to be undertaken for the benefit of SureWest and its ratepayers. The $12,486,000 Corporate Operations salaries adjustment recommended by ORA is not adopted.

H. 15% Expense Elimination

ORA recommended an across the board 15% disallowance in SureWest's test year operating expenses on the basis that SureWest's employees are recording the majority of their time to SureWest's regulated operations while performing duties for its affiliates and non-regulated operations. ORA derived this percentage disallowance, which equates to $9,007,000, from its "best estimate." ORA explained that it was not able to recommend a more precise disallowance because SureWest did not provide ORA with employee timesheets to account for actual employee hours spent performing non-regulated services for its parent company and affiliates and because ORA did not have the resources to investigate SureWest's time accounting further.[35]

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[34] Exhibit 34.

[35] Exhibit 41, p. 3-7.

SureWest acknowledged that ORA's examination of affiliated and non-regulated transactions in Application 99-03-035 disclosed that approximately $236,000 of SureWest's employees time per year over a three year audit period of 1997 through 1999 improperly recorded affiliate and non-regulated time to SureWest.[36] However, SureWest corrected the time keeping errors and reflected that impact in each of its base operating years used in arriving it test year estimates. ORA's own witness testified that it found no instances where a SureWest employee recorded or allocated its time to utility operations while working on affiliate or non-regulated matters.[37]

Absent evidence that SureWest employees are recording their time to SureWest's regulated operations while performing duties for affiliates and non-regulated operations there is no basis to impose an across the board 15% disallowance of SureWest's test year operating expenses. The $9,007,000 test year operating expense disallowance recommended by ORA is not adopted.

I. Depreciation

The $17,654,000 depreciation expense difference between SureWest and ORA was due to a difference in their respective plant level and represcription of depreciation rates. Test year depreciation expense should be recalculated based on the test year plant in service and depreciation rates adopted in this order. That recalculation results in a $23,709,000 depreciation expense for the test year.[38]

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[36] Exhibit 34, p. 10.

[37] Reporter's Transcript Vol. 4, p. 245.

[38] Depreciation expense was calculated by multiplying ORA's depreciation rates set forth in Exhibit 41 times SureWest's 2002 average plant in service set forth in Exhibit 23.

VI. Operating Taxes

The operating taxes difference between SureWest and ORA are in federal income tax, state income tax, taxes other than income, and deferred income tax, as detailed in the following tabulation.

CATEGORY	SUREWEST	ORA	DIFFERENCE
Federal Income Tax	$ 5,121,000	$ 21,309,000	$ 16,188,000
State Income Tax	1,967,000	5,529,000	3,561,000
Taxes Other Than Income	1,916,000	1,595,000	(321,000)
Deferred Income Tax	343,000	343,000	0
Total Operating Taxes	$ 9,348,000	$ 28,775,000	$ 19,428,000

SureWest and ORA used the same financial model to calculate taxes. Differences in the various tax categories resulted solely from differences in revenue, expense, and rate base estimates. Taxes recalculated based on the revenues, expenses, and rate base adopted in this proceeding for total company operations was $17,178,777 as detailed in Appendix A.

Taxes on the depreciation adjustment in Appendix A was based on the same 31.800% federal, 8.240% state, and .285% deferred operating tax percentages used by SureWest and ORA to calculate the operating tax impact of the depreciation adjustment set forth in column (x) of their joint comparison exhibit.

Total intrastate operating taxes of $13,368,520 set forth in Appendix A was approximated based on the same 63.46% ratio of total intrastate taxes (comprised of taxes other than income, state income tax, and federal income tax) to net income before taxes used by SureWest for intrastate operations set forth in Attachment 1 of Exhibit 34.

To the extent that SureWest or ORA deems a need to more accurately reflect intrastate income taxes, that party should provided detailed tax numbers as part of their respective comments to the ALJ's proposed decision.

VII. Rate Base

The rate base difference between SureWest and ORA are in plant in service, plant under construction, depreciation reserve and deferred taxes, as detailed in the following tabulation.

CATEGORY (a)	SUREWEST (b)	ORA (c)	DIFFERENCE[39] (d)
Plant In Service	$392,166,000	$325,428,000	$ 66,738,000
Plant Under Construction	16,358,000	2,420,000	13,938,000
Materials & Supplies	1,282,000	1,282,000	0
Working Cash	7,305,000	7,305,000	0
Depreciation Reserve	(190,592,000)	(181,646,000)	8,946,000
Deferred Tax	(15,475,000)	(15,540,000)	(65,000)
Customer Deposits	(181,000)	(181,000)	0
Total Rate Base	$210,863,000	$139,068,000	$ 71,795,000

A. Plant in Service

The $66,738,000 plant in service difference between SureWest and ORA was due to different estimating methodologies.

SureWest developed its test year 2002 plant in service estimate by adding its actual historical plant in service at the beginning of test year 2002 to its projected year-end 2002 plant in service balance and divided that result by two to arrive at a simple average test year plant in service. SureWest used this simplified method on the basis that it reflected SureWest's actual investment and approved budgeted additions for the test year. It is also the same method that SureWest used and the Commission adopted in SureWest's prior rate proceeding, 1996.

ORA rejected SureWest's method of estimating plant in service on the basis that competition in SureWest's service territory "…does not exist now and

39 Column (b) minus column (c).

in near future."[40] For example, ORA observed that although 70% of SureWest's estimated $392 million investment for the test year 2002 was for switching, circuit and outside plant equipment claimed by SureWest necessary to replace the technological obsolescence of its embedded investments and to meet competition, it found no evidence that SureWest was retiring obsolete technology and found no evidence to substantiate that SureWest needs to meet competition.[41]

ORA used an investment per access line method to estimate SureWest's plant in service for the test year. To derive its test year 2002 plant in service estimate, ORA started with SureWest's 1996 test year plant in service amount adopted by D.96-12-074 to establish a base investment per access line.[42] ORA adjusted that investment per access line base to reflect SureWest's 30% access line growth from 104,600 in 1996 to 135,986 in 2002 and applied a growth factor for the 15% inflation rate from 1996 to 2002.[43]

As a reality check on its investment per access line estimating method, ORA compared the trend in SureWest's investment per access line with the trends of Verizon and Pacific Bell. ORA concluded from that comparison that SureWest's 24% increase in investment per access line from $1,853 in 1996 to $2,295 in 2002 was excessive in comparison to Verizon's 16% decrease in investment per access line from $1,949 in 1996 to $1,638 in 2001 and Pacific Bell's

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[40] Exhibit 41, p. 5-4.

[41] *Id.*, p. 5-3.

[42] Commission decision that transformed SureWest from traditional rate of return to NRF regulation.

[43] Exhibit 41, p. 5-2 and p. 5-3.

7.21% increase in investment per access line from $1,658 in 1996 to $1,777 in 2001. Based on this reality check, ORA concluded that SureWest's test year 2002 plant in service estimate should be based on an investment per access line.

The investment per access line estimating method was also used by ORA in the 1996 rate proceeding of SureWest. In that proceeding ORA found that SureWest's average plant investment, a 40% increase in investment and a 20% increase in access lines for the five-year period from 1992 through 1996,[44] was contrary to the declining investment per access lines trend of the general industry. We found in that proceeding that "the evidence on plant in service per access line does not support the conclusion that the majority of firms have costs per access line that are increasing, decreasing or staying the same. Rather, of the 16 California companies for which there is data from 1991 through 1994, costs per access line decline for 5, stay the same for 5 and increase for 6. No particular trend is found in this data."[45] Similarly, we find no particular industry trend in investment per access line in this proceeding. As such, we decline to adopt ORA's plant in service estimate.

The estimating methodology used by SureWest to develop its test year 2002 plant in service estimate in this proceeding should be adopted. We use SureWest's actual historical plant in service at the beginning of test year 2002 as a base, similar to the method adopted in SureWest's prior rate proceeding and similar to our approach of using a base period of actual operating expenses to develop test year expenses. To that base we scrutinize investments embedded in

[44] This is in comparison to a 61% investment increase in six years from 1997 to 2002 with an access line increase of 30% over the same six years.

[45] 70 CPUC 2d, 88, 131 (D.96-12-074).

that base and investments projected for the test year. Although ORA found SureWest's investment growth to be higher than Verizon and Pacific it did not identify any investment SureWest made from 1996 to 2002 that was unreasonable or take exception to any specific investment budgeted in test year 2002. ORA also did not establish that SureWest's operation was comparable to Verizon and Pacific's operations. Hence, there is no basis to adjust SureWest's test year 2002 plant in service estimate for inappropriate investments.

In regards to our scrutiny of investments projected for the test year, ORA reminds us that SureWest has historically over-budgeted its capital expenditures, and has actually spent only 70% of budgeted amounts, particularly in computer, circuit, cable and conduit categories of operating plant. Because of that overestimate, SureWest's plant in service test year estimated additions for several plant categories were reduced by 30% in its prior rate proceeding.[46] However, absent evidence in this proceeding that SureWest has continued its prior trend of not implementing 30% of its budgeted investments since 1996, no adjustment to SureWest's test year additions is warranted. SureWest's total company test year 2002 plant in service estimate of $392,166,000 is adopted.

B. Plant Under Construction

The $13,938,000 plant under construction difference between SureWest and ORA was due to the use of the different estimating methodologies addressed in our prior plant in service discussion. Consistent with that discussion and conclusion of the plant in service estimating methodologies, SureWest's $16,358,000 plant under construction test year estimate is adopted.

[46] ORA reply brief, p. 18 and 70 CPUC 2d 88, 131 (D.96-12-074).

C. Working Cash

The $7,305,000 working cash component of rate base is not in dispute. SureWest calculated its working cash amount based on the Commission's Standard Practice U-16 simplified method. ORA accepted SureWest's estimate.

Working cash is used to compensate investors for funds used to pay operating expenses in advance of the revenue received from customers. Hence, differences, if any, in the timing and level of cash payments, cash receipts, income taxes and depreciation expense impact the amount of working cash.

Although the parties agreed on a test year working cash amount, the $2,521,000 revenue and $47,992,000 expense difference between the parties should have resulted in different working cash estimates. Irrespective of the parties working cash agreement, the test year working cash amount should be recalculated based on the Standard Practice U-16 simplified method, as detailed in Exhibit 21 and applied on the adopted revenue and expense estimates. That recalculation results in a $6,833,000 test year working cash component.[47]

D. Depreciation Reserve

The $8,946,000 depreciation reserve difference between SureWest and ORA is due to differences in methodology.

SureWest used actual recorded plant data through June 2001 as a base to calculate its test year depreciation reserve. Added to that base was forecasted plant data through December 31, 2002 consisting of 2001 budgeted plant data from June through December 2001 and test year 2002 budgeted plant data. SureWest then updated its depreciation reserve account to January 1, 2002 based

[47] Working cash adjustments are set forth in the test year 2002 company results of operations attached to this decision.

on depreciation rates authorized in its 1994 depreciation represcription proceeding. SureWest then conducted a depreciation represcription study to reflect changes in the remaining life, depreciation reserves and net salvage value that have occurred since its Commission adopted 1994 depreciation study as well as impacts from technological changes and competition.[48] That depreciation study resulted in a composite annual depreciation accrual rate of 18.54% and a composite 2002 depreciation expense rate of 9.40%.

ORA used SureWest's actual recorded plant data for 1999 as a base to calculate test year depreciation reserve. To that base ORA added 2000, 2001, and 2002 estimated plant additions for SureWest. ORA also conducted a depreciation represcription study for SureWest's test year 2002. That study resulted in ORA applying technical updates to SureWest's 2000 and 2001 plant data to arrive at a depreciation accrual amount and a composite 2002 depreciation expense rate of 5.85%.[49]

1. Base Plant in Service

Plant data is the first of three differences between the method SureWest and ORA used to estimate the test year 2002 depreciation reserve. SureWest used its recorded plant in service and budget approved plant changes for both its plant in service and depreciation reserve estimates. ORA used a plant in service estimate based on a 1996 average access line investment adjusted for access line growth and inflation while its depreciation reserve estimate was

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[48] Exhibit 19.

[49] A technical update reflect changes in depreciation rates due to the composition of plant additions and retirements, and changes in the reserve level while maintaining the same average service life and future net salvage prescribed in the last adopted depreciation study.

based on SureWest's recorded 1999 plant in service plus estimated plant changes subsequent to 1999.

ORA's use of a different plant in service base for its plant in service and depreciation reserve estimates resulted in a mismatch between its plant in service and depreciation reserve estimates.[50] Depreciation reserve should be based on the adopted 2002 plant is service estimate.

2. Technical Updated Rates

Technical updated rates applied to the 2000 and 2001 years by ORA is the second difference between SureWest and ORA in estimating the test year depreciation reserve. While SureWest used its 1994 depreciation represcription rates for the period through December 31, 2001 ORA applied technical updated depreciation rates to the 2000 and 2001 years.

The 1994 depreciation represcription rates used by SureWest were reevaluated and affirmed in our 1997 reevaluation of depreciation rates for continued use in 1998.[51] Subsequent depreciation reviews were eliminated for SureWest in 2001[52] and SureWest has not sought to change or been authorized to change its depreciation rates by either represcription or technical update since that time. Hence, SureWest's 1994 depreciation represcription rates are still in effect.

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[50] ORA based its depreciation reserve amount on approximately $56,000,000 more plant ($381,281,000 versus $325,428,000) than it proposed for the test year plant in service. *See* Exhibit 42, Table 5 and Exhibit 41, Table 7-1, respectively.

[51] D.97-12-029, dated December 3, 1997, *mimeo.*, p. 3. Also, 77 CPUC2d at 99 identified, but not reported.

[52] Ordering Paragraph 9 of D.01-06-077, dated June 28, 2001, *mimeo.*, p. 88.

ORA's technical updating of SureWest's 2000 and 2001 depreciation retroactively adjusted SureWest's depreciation for events that have occurred in the past. ORA provided no reason why a technical updating of depreciation was warranted for the prior 2000 and 2001 years and provided no reason why such updating should be made on a retroactive basis, in conflict with the Commission's practice of setting rates on a prospective basis only.

Test year depreciation reserve should be based on SureWest's 1994 adopted depreciation represcription rates through December 31, 2001 and test year 2002 adopted depreciation represcription rates.

3. Depreciation Represcription

Depreciation represcription methodology is the third difference between SureWest and ORA.

SureWest's depreciation study was based on a technological obsolescence forecast that substituted an established technology with a newer technology, such as copper with fiber.[53] This substitution analysis model shortens the depreciation lives of the established technology investments as the new technology improves and becomes superior.[54]

ORA's depreciation study was based on the Commission's Standard Practice U-4 "Determination of Straight-Line Remaining Life Depreciation Accruals." This method determines the remaining life of investments based on judgment as to the future effect of wear and tear, decay, action of the elements, inadequacy and obsolescence. In special cases other factors may be important, such as anticipated changeovers to new or improved major units of plants, and

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[53] Reporter's Transcript, Vol. 2, p. 132.

[54] Exhibit 20, p. 65.

other specific plans of management. To arrive at a satisfactory estimate of future conditions, the past experience generally gives indications that may be used as a major element in the remaining life estimate. The weight given to past experience depends upon extent to which conditions affecting service life in the future are expected to be similar to or different from those in the past. However, substantial weight is generally given to results of past experience in the same or comparable properties.[55]

ORA accepted SureWest's proposed depreciation parameters and rates for 15 of the 40 subaccounts studied.[56] We concur.

ORA disagreed with SureWest on the appropriate depreciation rates for five of the 40 subaccounts where the present reserve level is at or close to 100%. These accounts are Office Equipment – Data Handling, Office Equipment – Official CPE, Office Equipment – Other, Circuit Equipment – Analog (LRS), and Circuit Equipment – Analog (ALM). SureWest used whole life rates for these accounts. ORA used remaining life rates for estimating the depreciation accruals for these accounts on the basis that additional depreciation should not be allowed because the plant investment for those accounts are fully recovered, or close to it.[57] To do other than that proposed by ORA would result in depreciation being accrued in excess of the actual investment and increase

[55] Exhibit 42, p. 2 and p. 3.

[56] *Id.*, p. 4 and p. 5.

[57] *Id.*, p. 5.

operating expenses unnecessarily. ORA's proposed depreciation rates for these five subaccounts either fully or almost fully depreciated are adopted.

ORA also disagreed with SureWest on the appropriate depreciation rates for the remaining 20 non-technology and technology accounts.[58] Non-technology accounts included motor vehicles and buildings and technology accounts included central office switches and cable accounts.

SureWest used an industry based salvage analysis for its non-technological accounts in place of detailed historical salvage value information not available within the company to forecast future salvage values. ORA disputed the unavailability of detailed historical data within the company because SureWest had used its own historical data to forecast future net salvage value for its 1994 and 1991 depreciation represcription studies.[59]

SureWest's reliance on industry data for non-technical accounts is not necessarily representative of SureWest's actual experience and should be rejected. ORA's forecast of service lives and future net salvage values based on SureWest's prior data and review of Federal Communications Commission recommended ranges is appropriate. The represcription rates recommended by ORA for SureWest's non-technical accounts are adopted.

For its technology accounts, SureWest claimed that shorter lives are appropriate due to new, more efficient technology and significant change in the competitive environment between 1997 and 2002 that require replacement of an obsolete network more so today than in 1997, supported by a substitution

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[58] *Id.*, p. 5 through p. 9.

[59] *Id.*, p. 7.

analysis model.[60] However, SureWest's substitution analysis model forecast, Exhibit 20, cannot be scrutinized for reliability because it was introduced, examined, and received into evidence as an incomplete document. That exhibit consisted of even pages 2 through 14 and odd pages 17 through 73. Noticeably missing from that exhibit were odd pages 1 through 15 and even pages 16 through 72.

Irrespective of the validity of Exhibit 20, ORA's independent analysis of SureWest's switching, circuit, and cable accounts showed that SureWest is currently investing in the same technology it was investing in 10 years ago.[61] For example, SureWest doubled its investment in copper cable accounts in the last eight years without retiring any of this technology deemed obsolete due to new technology.[62] Hence, SureWest's substitution of established copper technology investments with new fiber technology investments in its substitution analysis model is not representative of SureWest's actual or forecast investment experience within its service territory.

SureWest further attempted to justify its substitution analysis model on the basis that the Commission considered and rendered a decision, D.97-12-034, on the same substitution analysis model in a 1977 GTE California, Incorporated (GTE) application for approval of 1998 depreciation rates.[63] A review of that decision affirmed that GTE used a substitution analysis model, the

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[60] Exhibit 20.

[61] Exhibit 42, p. 7 through p. 9.

[62] *Id.*, p. 8.

[63] Exhibit 76.

initial result of which was a $93 million requested increase in depreciation expense.

However, that decision also stated that GTE subsequently used the Standard Practice U-4 method in response to an ORA protest of GTE's use of a substitution analysis model. GTE's use of the Standard Practice U-4 resulted in GTE reducing its requested $93 million depreciation expense increase to $83 million. GTE further reduced that $83 million depreciation expense impact to $55 million based on ORA's Digital Switching plant account forecast of economic lives. The difference between the substitution analysis model and Standard Practice U-4 model result in that GTE proceeding was approximately 60% or $38 million difference from $93 million to $55 million between the two methods, of which the $55 million amount based on Standard Practice U-4, was adopted.

For the above reasons, the substitution analysis model is not adopted for setting SureWest's test year depreciation expense and depreciation reserve. The depreciation rates derived from ORA's use of Standard Practice U-4 is adopted for setting SureWest's test year 2002 depreciation expense and depreciation reserve. These depreciation rates are set forth in Appendix B.

A. Deferred Taxes

The $65,000 deferred tax difference between SureWest and ORA is due to different plant in service and depreciation reserve estimates. The deferred tax should be recalculated based on the plant in service and depreciation reserve adopted in this proceeding. That recalculation results in a test year deferred tax of $15,667,848, as detailed in Appendix A.

VIII. Rate Design Issues

SureWest submitted three rate design proposals in this proceeding. The first rate design proposal pertained to the $11.5 million annual CHCF-B payment used to offset its intrastate regulated operating expenses. The second rate design proposal pertained to an offset of its actual CHCF-B draws. The third rate design proposal pertained to existing billing surcharges, including surcharges and surcredits relating to Z-factor adjustments into residential access line rates.

A. $11.15 Million Annual CHCF-B Funding

SureWest prepared a test year 2002 results of operations compliance filing to determine the extent of its dependence on the $11.5 million payment from the CHCF-B fund. Based on its analysis, the original total revenue requirement deficiency shown on SureWest's September 17, 2001 compliance filing was $21,227,897. That total revenue requirement deficiency was updated in its May 17, 2002 supplemental testimony to $22,062,752, and again in its October 4, 2002 rebuttal testimony to $24,646,100. Based on each of these revenue requirement shortfalls, SureWest demonstrated that the CHCF-B funding was a significant portion of its revenues, approximately 11% of state-regulated revenues, cover its costs of providing telephone services to the customers in its service territory.

Absent the $11.5 million, SureWest would not recover its cost to provide regulated services. Hence, it concluded that $11.5 million contributed to the provision of SureWest's entire regulated telephone operations must continue so that it may recover its costs for all areas of providing regulated telephone services.

SureWest acknowledged that the Commission has already determined in D.00-11-039 and in D.02-05-009 that the CHCF-B may not be relied on as a permanent funding source and considered alternative sources. It previously considered eight alternative sources in A.99-08-043, none of which SureWest deemed to be a viable replacement for the CHCF-B funding. These alternative funding sources included spreading the revenue replacement between residential and business exchange access service; increasing current surcharges on access, toll and local services; spread the entire amount over residential exchange access services; and, spreading the entire amount over residential flat rate exchange access services only.

SureWest did compute the impact of recovering the CHCF-B funding from increases in its current rates which are already the highest rates among its competitive telecommunication carriers. For example, SureWest's existing monthly flat rate of $18.90 already exceeds Pacific's $10.69 rate, Verizon's $17.25 rate, Frontier's $17.45 rate, and Sierra Telephone's $16.45 rate. Because SureWest's rates for residential access line service currently are set at prices below their respective costs while the average monthly revenue from its business customers exceeds the cost associated with provision of an access line, it considered increasing residential access line rates only. If residential access lines were used to replace the CHCF-B funding, the residential flat line rate would need to increase 45% to $33.11 from $22.87 and residential measured rate service 45 % to $22.68 from $15.67. These increases would not cover the projected costs of providing an access line and move SureWest's basis rates substantially above its competitive telecommunication carriers.

A cost proxy model (CPM) was adopted in D.96-10-066 to establish the amount of support carriers should receive from the CHCF-B, based on cost data from the larger LECs. SureWest contends that the adopted CPM understated the amount of CHCF-B funding support it requires to maintain rates comparable to those charged in Pacific's adjacent exchanges. For example, much of the north area of SureWest where substantial growth has taken place is covered by an ancient volcanic flow type of soil known as Mertin, which cannot be excavated using conventional equipment and techniques. Its trenching cost in the easternmost portion of its service territory is also expensive because the soil ranges from sand to solid granite within only a few feet of the surface and because major water distribution lines up to 60 inches in diameter are prevalent within the area.

SureWest concluded from its review of alternative funding sources that any change in its basic rates would keep the rates of SureWest among the highest basic rates in California, impact ULTS funding, result in rate shock, encourage residential customers to migrate to its competitors, and the Commission has not undertaken a review of the CHCF-B or CPM since 1996 even though D.96-10-066 provided for such a review to take place every three years. It also concluded that any change in its rates at this time would not comply with the universal service goals of the Commission and the Legislature. SureWest recommended that its $11.5 million CHCF-B funding continue on an interim basis until the Commission completes a triennial review of both the CHCF-B and the CPM.

ORA disagreed with SureWest. Based on ORA's review and analysis of SureWest's test year 2002 operations, it found that SureWest was earning a total company return on rate base of 29.23%.[64] The return on rate base, substantially above the 10.00% benchmark return on intrastate rate base authorized for SureWest, demonstrated to ORA that SureWest did not need the $11.5 million

[64] Joint Comparison Exhibit, ORA adjusted regulated company net operating income divided by ORA adjusted total regulated company total rate base.

CHCF-B funding source. Hence, it opposed a continuation of the $11.5 million payment to SureWest. However, should the Commission decide to allow SureWest to recover all or part of the $11.5 million that it requests, ORA recommended adoption of the following conceptual rate design:

a. Increase the rates of LEC services to cost except for the basic access line services that are currently priced below cost.

b. Increase the rates of LEC services, except for the basic access line service, by 100%.

c. Increase the rates of basic access line services by 15%.

d. Recover any remaining portion by a billing surcharge applied to LEC services.

There was a substantial difference in SureWest's test year 2002 total company results of operations between SureWest and ORA. Based on the joint comparison exhibit, SureWest estimated a total company 4.60% return on a rate base of $210,863,288 and ORA estimated a total company 29.30% return on a rate base of $139,068,213. Comparable intrastate return on rate base was not provided.

Upon consideration of all the revenue and expense differences between SureWest and ORA we concluded that SureWest would earn a 9.38% return on a $216,978,369 total company rate base for the test year 2002 and a 4.44% return on a $173,273,568 intrastate rate base for that same test year, as set forth in Appendix A. For SureWest to arrive at its authorized 10.00% benchmark return on intrastate rate base it would need to earn an additional $4,703,135 in revenue above the $11,500,000 CHCF-B funding for a total of $16,203,135 on the

$173,273,568 of intrastate rate base.[65] Irrespective of whether we change our position on some of the individual results of operation adjustments in this proceeding, SureWest would still need a majority, if not all, of the $11.5 million funding absent a substantial increase in its basic rates and violate the universal service goals of the Commission and the Legislature set forth in § 728 and § 739.3.[66] SureWest should be afforded an opportunity to substantiate that the application of the adopted CPM based on dated cost data from larger LECs is not appropriate for SureWest.

We concur with SureWest that its $11.5 million CHCF-B funding should continue on an interim bases until a review of both the CHCF-B and CPM has been undertaken. In this regard, SureWest should prepare a CPM based on its current cost data. The results of this study and resulting impact on its rates, on the ULTS fund and on the CHCF-B fund, shall be filed within 12 months after the effective date of this decision by SureWest as an application for authority to modify the CPM for SureWest. SureWest shall serve an electronic mail notice to all certificated telecommunications carriers so that they may assess the impact, if any, on their respective ULTS and CHCF-B payments and draws.

B. Offset of CHCF-B Draws

Pursuant to D.02-03-009, SureWest submitted a rate design proposal for reducing its rates and price ceilings to offset its draws from the CHCF-B by an

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[65] Rate base of $173,273,568 times 10.00% authorized base return on rate base minus $7,697,537 net operating revenue time a 1.6826 net to gross multiplier set forth in Tab I of Exhibit 35.

[66] These code sections require the establishment of a fair and equitable local rate structure that promotes the goal of universal telephone service and mitigate any disparity in the rates charged by other telephone companies for comparable service.

amount equal to SureWest's actual draws from the CHCF-B during the most recent 12 month period for which data was available at the time a proposal is submitted. That most recent 12 month period from March 2001 through February 2002 resulted in a $387,256 draw from the CHCF-B.

SureWest proposed that the entire draw amount be applied as a reduction in its business access line rates. Under this proposal, business access line rates would be reduced from $25.90 to $24.85.

SureWest made this recommendation because its business services were recovering a disproportionate share of its costs when compared to its residential services. Business customers pay an average of $46.38 per month for their telephone services, which includes the basic access line rate and average usage charges. Whereas, residential customers contribute only $24.51 on average, an amount below the 2000 NECA combined loop and switching cost of $40.34.

In the Commission's order finalizing rules governing universal service objectives in a competitive telecommunications environment the five large and mid-size local exchange companies there existing, which included SureWest, were given the opportunity to decide what rates or price caps should be reduced downward to permanently offset the explicit CHCF-B funding support.[67] This rate design proposal should be adopted because it mitigates the disproportionate contribution to SureWest's costs between business and residential services and is consistent with D.96-10-066. SureWest should file an advice letter that incorporates its rate design proposal of applying its CHCF-B draw from the

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[67] D.96-10-066, 68 CPUC2d 524 at 630, (1996); midsize carrier Control was acquired by GTE California, predecessor of Verizon.

period March 2001 through February 2002 as a reduction to its business access line rates.

C. Billing Surcharges and Surcredits

Although SureWest was not specifically requested to submit a rate design proposal to incorporate its billing surcharges and surcredits into rates it did so on the basis that it would reduce customer confusion over a myriad surcharges that appear on customers' bills and that this investigation was opened to review SureWest's revenue requirement and rate design.

SureWest proposed to incorporate existing billing surcharges of $4,466,542, after netting its surcharges and surcredits, into its residential access line rates to further mitigate the disproportionate share of its costs between residential and business services. Under this proposal there would be no change in its business access line rates. However, its residential access line rates would increase 21%. The residential flat access line rate of SureWest would increase to $22.87 from $18.90 and its residential measured access line rate to $15.67 from $12.95.

ORA opposed this proposal on the basis that it unfairly burdens residential customers.

Irrespective of whether this redistribution of surcharges takes place now or later, the Universal Lifeline Telephone Service (ULTS) customers of SureWest would continue to be charged the same rates. However, the ULTS fund would be impacted by the proposed change in the residential access line rates because the ULTS program funds the difference between the ULTS rate and the residential access line rate.

To the extent that the CHCF-B is used as a continuing interim source of funding for recovery of the $11.5 million, SureWest proposed to postpone the incorporation of billing surcharges into residential rates until a triennial review of the CPM and CHCF-B are completed and a final rate design is determined in this proceeding. This postponement would reduce customer confusion that SureWest believes would likely occur with multiple rate and billing changes absent postponement.

Although the Commission concurs with SureWest's desire to simplify customers' bills, it is premature to incorporate SureWest's billing surcharges and surcredits into residential access line rates at this time. As recognized by SureWest, this proceeding was intended only for the review of the revenue requirement relating to the $11.5 million.[68] To assess the reasonableness of SureWest's proposal it is necessary to review the purpose of each surcharge and surcredit, services to which the individual charge and credit is currently applied to; and changes in access line rates, CHCF-B draws, and impact on the ULTS program. For these reasons, we reject the proposal to incorporate billing surcharges and surcredits into base rates. However, SureWest may file a separate application or advice letter providing this information and seek authority to incorporate its billing surcharges and surcredits into base rate.

IX Category of Proceeding

The Scoping Memo and Ruling of the Assigned Commissioner confirms the Commission's determination that the category for this proceeding is ratesetting. Any party could have appealed the categorization pursuant to Rule 6.4, but no appeal was filed prior to the PHC. The *ex parte* rules as set forth in Rule 7 apply to this proceeding.

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[68] Exhibit 26, Tab 1, p. 4, footnote 2.

X. Comments on Proposed Decision

The proposed decision of the ALJ in this matter was mailed to the parties in accordance with Pub. Util. Code Section 311(d) and Rule 77.1 of the Rules of Practice and Procedure.

XI. Assignment of Proceeding

Michael R. Peevey is the Assigned Commissioner and Michael J. Galvin is the currently assigned ALJ in this proceeding.

Findings of Fact

1. This investigation was opened to determine the appropriate source of permanent funding for the annual $11.5 million SureWest receives from the CHCF-B.

2. There is a total company test year 2002 difference of $31 million in net operating income and $72 million in rate base between SureWest and ORA.

3. SureWest is authorized a 10.00% benchmark return on rate base.

4. Undisputed test year estimates included operating revenue from local and long distance services and rate base components of materials and supplies and working cash.

5. SureWest implemented a parent company reorganization plan approved by the Commission on January 1, 2002.

6. Prior to its corporate realignment, SureWest allocated its land and building costs to affiliated companies based on their usage of SureWest's land and buildings. Subsequent to the corporate realignment, all of SureWest's land and building costs were charged to its parent company and then allocated to each affiliate, including SureWest, based on usage.

7. Section 851 requires a public utility to obtain Commission authority to sell, lease, assign, mortgage, or otherwise dispose of public utility property.

8. SureWest neither requested nor addressed the sale or transfer of public utility property.

9. SureWest attributed its $850,000 uncollectible adjustment to the loss of anticipated revenue from companies that recently filed for bankruptcy.

10. The mere filing for bankruptcy does not automatically forgive the filer from paying its debts.

11. SureWest was silent on whether the bankruptcy court acted on, authorized debt forgiveness, or established payment terms for the companies that recently filed for bankruptcy.

12. SureWest was silent on whether the companies that filed for bankruptcy would continue to provide SureWest with its estimated revenue during their respective bankruptcy proceeding or subsequent approval of any bankruptcy.

13. SureWest was silent on whether the bankruptcy court would or would not provide payment terms or a guarantee of payment for future service from SureWest during the bankruptcy proceeding.

14. SureWest was silent on whether the customers of the companies that filed for bankruptcy would switch their telecommunications needs directly to SureWest or interconnect with other competitors that interconnect with SureWest.

15. A $66,000 difference in the growth and output factor between SureWest and ORA occurred because ORA used SureWest's 3.87% growth and output factor while SureWest used an updated 4.00% factor.

16. SureWest used a 3.1% CPI rate for the test year, which is higher than the reported 1.90% CPI change for 2002 from 2001 and higher than the 2.80% CPI change from 2001 from 2000.

17. An obligation to pay reciprocal compensation is a new expense imposed on SureWest.

18. Reciprocal compensation expense is a cost of doing business.

19. SureWest's 2001 affiliated directory publishing agreement requires SureWest to begin paying for the printing and distribution costs of its directory.

20. SureWest normalized its directory printing and distribution costs prior to applying escalation, growth and output, and productivity factors to arrive at its test year directory expense.

21. The escalation methodology SureWest used to calculate its test year directory printing and distribution costs is not in dispute.

22. Miscellaneous items differences between SureWest and ORA totaling $215,000 related to SureWest's name change, corporate realignment, shareholder relations, travel, meals, entertainment, membership and dues, network security, legal costs and various errors and omissions.

23. SureWest complied with all the adjustments specified in D.01-06-077 and made the required adjustments to its 1999, 2000, and 2001 base years used to derive test year 2002 estimates.

24. Regulatory expenses are compensable by means of the shareable earnings calculation under NRF.

25. Termination of the DCP between Pacific and SureWest results in SureWest incurring additional costs for terminating access for intraLATA toll calls that it delivers to Pacific and incurring cost of providing directory assistance service which it did not pay or incur under the DCP.

26. Termination of the DCP between Pacific and SureWest provides additional revenue to SureWest for calls originating from Pacific exchanges that terminate

in SureWest's exchange and additional intraLATA toll revenue that SureWest would collect from its customers for providing intraLATA toll service.

27. SureWest included local compensation implementation costs in its test year expenses.

28. The Commission extended the coverage of the rules adopted for local exchange competition in Pacific Bell and GTEC service territories to SureWest. These rules include a requirement that local exchange competition implementation costs be accrued in a memorandum account and reviewed in the Local Exchange Competition docket, R.95-04-043 and I.95-04-044.

29. Increased energy, insurance and pension costs impacted SureWest and other companies.

30. The NRF mechanism allows NRF companies like SureWest to seek a rate increase for costs associated with exogenous events by means of an application or by an annual price cap filing.

31. SureWest does not intend to file an application for recovery of its increased energy, insurance and pension costs.

32. SureWest proposed to accelerate the rate of depreciation for its STP switches outside of the composite depreciation represcription review being undertaken in this proceeding.

33. Early retirement of investments is only one of a multitude of factors considered in a depreciation represcription review.

34. The salaries of the Corporate Operations employees transferred to SureWest's parent company were included in SureWest's test year expenses on the basis that the activities performed by these employees for SureWest's regulated operations would not change.

35. The transfer of Corporate Operations employees and business units was undertaken by SureWest as part of its implementation of a parent company reorganization plan approved by the Commission.

36. The Corporate Finance Department transferred to SureWest's parent company continues to provide the same corporate accounting, treasury, and investor relations functions to the utility operations of SureWest that it provided prior to the transfer of the department.

37. The Administrative Service department transferred to SureWest's parent company continues to provide the same human resources, purchasing administration and distribution services, fleet services, maintenance and administration of property, and safety and risk management functions to the utility operations of SureWest that it provided prior to the transfer of the department.

38. The Corporate Marketing Department transferred to SureWest's parent company continues to provide the same planning and research, marketing communications, and public relations functions to the utility operations of SureWest that it provided prior to the transfer of the department.

39. The ITS Department transferred to SureWest's parent company continues to provide the same information technology, architecture, new systems development and integration, and corporate data security functions to the utility operations of SureWest that it provided prior to the transfer of the department.

40. The External Relations Department transferred to SureWest's parent company continues to provide the same FCC and CPUC regulatory functions for the utility operations of SureWest that it provided prior to the transfer of the department.

41. Time keeping errors discovered in A.99-03-035 were excluded from the base operating years SureWest used to arrive at its test year operating expense estimate.

42. ORA found no instances where a SureWest employee recorded or allocated its time to utility operations while working on affiliate or non-regulated matters.

43. The depreciation expense difference between SureWest and ORA was due to a difference in their respective plant level and represcription rates.

44. SureWest and ORA used the same financial model to calculate taxes.

45. SureWest developed its test year plant in service estimate by adding its actual historical plant in service at the beginning of the test year to its projected year-end balance and divided that total by two to arrive at a simple average test year plant in service.

46. SureWest used the same simplified plant in service method in this proceeding that was adopted in its prior rate proceeding.

47. ORA used a similar investment per access line estimating method to determine an appropriate test year plant in service estimate in this proceeding that was rejected in SureWest's prior rate proceeding.

48. The test year plant under construction estimate difference between SureWest and ORA was due to the use of the different estimating methodologies used by the respective parties to develop their respective test year plant in service estimate.

49. SureWest's rate base working cash component was based on the Standard Practice U-16 simplified method.

50. The Standard Practice U-16 simplified depreciation method is used to calculate straight-line remaining life depreciation based on judgment as to the

future effect of wear and tear, decay, action of the elements, inadequacy and obsolescence. Other factors such as anticipated changeovers to new or improved major units of plants, and other specific plans of management are also considered.

51. There is no dispute on the depreciation parameters and rates for 15 of SureWest's 40 depreciation accounts.

52. SureWest used an "industry" based salvage analysis for its non-technological accounts in place of detailed historical salvage value information.

53. ORA used SureWest's prior data and FCC recommended service life ranges to forecast service lives and future net salvage values.

54. SureWest used a substitution analysis model forecast for its technical accounts even though it is investing in the same technology it was investing in 10 years ago.

55. There is a substantial difference between the results from a substitution analysis model and Standard Practice U-4.

56. The depreciation represcription rates used by SureWest up to the beginning of test year 2002 were approved in 1994, reevaluated in 1997 and affirmed for continued use in 1998.

57. ORA applied technical updated depreciation rates to its 2002 and 2001 plant in service estimates on a retroactive basis.

58. The difference in deferred taxes between SureWest and ORA was due to the use of different plant in service and depreciation reserve estimates.

59. The Commission determined in D.00-11-039 and in D.02-05-009 that the CHCF-B may not be relied on as a permanent funding source for SureWest.

60. SureWest's existing monthly flat rate of $18.90 already exceeds Pacific's $10.69 rate, Verizon's $17.25 rate, Frontier's $17.45 rate, and Sierra Telephone's $16.45 rate.

61. SureWest's rates for residential access line service currently are set at prices below their respective costs.

62. A CPM was adopted in D.96-10-066 to establish the amount of support carriers should receive from the CHCF-B based on cost data from the larger LECs.

63. SureWest contends that the adopted CPM understated the amount of CHCF-B fund support it requires to maintain rates comparable to those charged in Pacific's adjacent exchanges.

64. Any change in its basic rates would keep the rates of SureWest among the highest basic rates in California.

65. The Commission has not undertaken a review of the CHCF-B or CPM since 1996.

66. Based on the joint comparison exhibit, SureWest estimated a total company return on rate base of 4.60% and ORA estimated a total company return on rate base for SureWest of 29.30%.

67. SureWest submitted a rate design proposal for reducing its rates and price ceilings to offset its draws from the CHCF-B fund by an amount equal to its actual draws from March 2001 through February 2002.

68. SureWest's business services recover a disproportionate share of its costs when compared to its residential services.

69. Decision 96-10-066 gave SureWest the opportunity to decide what rates or price caps should be reduced downward to permanently offset its CHCF-B draws.

Conclusions of Law

1. The undisputed estimates set forth in the joint comparison exhibit excluding working cash are reasonable, consistent with law and in the public interest.

2. SureWest's change in accounting and allocating land and building cost based on usage to itself and its affiliates did not result in any increased cost to SureWest.

3. ORA's $1,771,000 miscellaneous revenue adjustment should not be adopted.

4. Should SureWest want to actually sell, transfer, or lease public utility property it will need to file a Section 851 application.

5. Approval of an allocation method for office space in this proceeding should not be construed as authority to transfer any of SureWest's public utility property to any of its affiliates.

6. SureWest has not substantiated the need to increase its test year uncollectibles.

7. SureWest's updated growth and output factor reflects reality and should be adopted for the test year.

8. SureWest's simple averaging of CPI should not be adopted because it failed to reflect the downward trend of inflation in the period under consideration.

9. Reciprocal compensation is a new expense properly includable in SureWest's revenue requirements as a cost of doing business.

10. The undisputed escalation methodology used by SureWest to estimate its directory printing and distribution costs should be adopted.

11. SureWest should fully address how directory revenue is being shared with its affiliated directory company in its next NRF proceeding.

12. The minute differences of various activities in the miscellaneous items adjustment of ORA are not material and should not be adopted.

13. The $2,006,000 of prior adopted adjustments proposed by ORA is already reflected in the test year 2002 estimates.

14. SureWest may apply for recovery of this rate case's expenses as an exogenous factor.

15. The ORA access cost and directory assistance expense adjustment should not be adopted because it does not match revenue with related expenses. Although ORA included access and directory assistance revenue in test year operating revenues it excluded the associated expenses.

16. The impact of any early retirement of STP switches should be considered as part of the depreciation represcription review.

17. The salaries of Corporate Operations employees in those departments transferred to SureWest's parent company that continue to perform the same activities for SureWest's utility operations prior to being transferred should continue to be included in SureWest's test year expenses.

18. Absent evidence that SureWest employees are recording time spent on SureWest's regulated operations while performing duties for affiliates and non-utility regulated operations there is no basis to impose an across the board 15% disallowance of SureWest's test year operating expenses.

19. Test year depreciation should be recalculated based on the adopted test year plant in service and depreciation rates.

20. Taxes should be recalculated based on the adopted revenues, expenses, and rate base.

21. The same simplified plant in service method adopted in SureWest's prior rate proceeding should be adopted in this proceeding.

22. Test year plant under construction should be based on the same simplified method used for test year plant in service.

23. Test year working cash should be recalculated using test year adopted revenue and expense estimates based on the Standard Practice U-16 simplified method.

24. Technical updated depreciation rates should not be applied on a retroactive basis.

25. The depreciation rates derived from ORA's use of Standard Practice U-4 should be adopted for setting SureWest's test year depreciation expense and depreciation reserve.

26. Deferred taxes should be recalculated based on the adopted test year plant in service and depreciation reserve estimates.

27. Any replacement of the CHCF-B funding for higher residential rates would not cover the projected costs of providing an access line and would move its basic rates substantially above its competitive telecommunications carriers.

28. Upon consideration of all the revenue and expense differences between SureWest and ORA, SureWest would earn a 9.38% return on a $216,978,369 total company rate base for the test year 2002 and a 4.44% return on a $173,273,568 intrastate rate base for that same test year, as set forth in Appendix A.

29. For SureWest to arrive at its authorized 10.00% benchmark return on intrastate rate base it would need to earn an additional $4,703,135 in revenue above the $11,500,000 CHCF-B funding for a total of $16,203,135 on the $173,273,568 of intrastate rate base.

30. Irrespective of whether we change our position of some of the individual results of operation adjustments in this proceeding, SureWest would still need a majority, if not all, of the $11.5 million funding absent an increase in its basic rates and violate the universal service goals set forth in § 728 and § 739.3.

31. SureWest should continue to receive the $11.5 million CHCF-B funding on an interim basis.

32. The rate design proposal of SureWest to offset its CHFC-B draws during the period March 2001 through February 2002 should be adopted.

O R D E R

IT IS ORDERED that:

1. Roseville Telephone Company (SureWest) shall continue to receive an annual $11.5 million California High Cost Fund (CHCF) B funding on an interim basis.

2. SureWest shall prepare a cost proxy model (CPM) based on its current cost data. The results of this study and resulting impact on its rates, on the Universal Lifeline Telephone Service (ULTS) fund, and on the CHCF-B fund shall be filed by SureWest as an application for authority to modify the CPM for SureWest within 12 months after the effective date of this decision. SureWest shall serve an electronic mail notice to all certificated telecommunications carriers so that they may assess the impact, if any, on their respective ULTS and CHFC-B payments and draws.

3. SureWest shall file an advice letter with the Commission's Telecommunications Division to incorporate its rate design proposal of applying its CHCF-B draw from the period March 2001 through February 2002 as a

reduction to its business access line rates. The advice letter filing shall become effective when authorized, but not less than 5 days after filing.

4. SureWest shall not sell, lease, assign, mortgage, or otherwise dispose of public utility property prior to Commission authority pursuant to § 851 of the Public Utilities Code.

5. SureWest shall fully address how directory revenue is being shared with its affiliated directory company in its next new regulatory framework proceeding.

6. SureWest shall file as part of its application to modify its CPM set forth in Ordering Paragraph 2, a report on the amount and nature of its actual implementation costs for local exchange competition from September 24, 1997 to the present. SureWest shall also propose a recovery method for its actual implementation costs. Notice of its application shall be provided to all parties to the Local Competition Exchange proceeding, Rulemaking 95-04-043.

7. Investigation 01-04-026 is closed.

This order is effective today.

Dated _____________________, at San Francisco, California.

APPENDIX A

Line No.	Description	RTC Adjusted Total Regulated Company TEST YEAR 2002	Uncollectibles	Inflation Factor Difference	Rate Case Expense Amortized Over 3 Years	Local Competition Implementation Costs Amortized Over 3 Years	Energy, Insurance & Pension Adjustment	Depreciation Difference	Adjusted Total Regulated Company	Exhibit 34, Tab 1 Intrastate % TEST YEAR 2002	Adjusted Total Regulated Company
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)	(k)	(l)
	OPERATING REVENUE										
1	Local Network Revenues	$59,219,207	$0	$0	$0	$0	$0	$0	$59,219,207	100.0000%	$59,219,207
2	Network Access Service - STATE	16,963,486	0	0	0	0	0	0	16,963,486	100.0000%	16,963,486
3	Long Distance Network Service	2,367,824	0	0	0	0	0	0	2,367,824	100.0000%	2,367,824
4	Total Network Access Service - IS	30,363,607	0	0	0	0	0	0	30,363,607	0.0000%	0
5	Miscellaneous	13,366,340	0	0	0	0	0	0	13,366,340	91.0872%	12,175,025
6	Uncollectibles	(1,092,499)	850,099	0	0	0	0	0	(242,400)	100.0000%	(242,400)
7	**TOTAL OPERATING REVENUE**	121,187,964	850,099	0	0	0	0	0	122,038,064		90,483,142
	OPERATING EXPENSES										
8	Plant Specific	16,386,295	0	(181,406)	0	(7,710)	(437,343)	0	15,759,836	79.1464%	12,473,343
9	Plant Non-Specific (less Depr.)	12,861,536	0	(140,657)	0	(20,528)	(478,480)	0	12,221,871	79.5900%	9,727,387
10	Depreciation & Amortization	37,269,239	0	0	0	0	0	(13,559,953)	23,709,286	78.7482%	18,670,636
11	Customer Operations	17,119,173	0	(189,077)	0	(64,287)	(382,110)	0	16,483,699	90.2291%	14,873,093
12	Corporate Operations	18,517,085	0	(201,897)	(1,001,214)	(494,126)	(487,304)	0	16,332,544	83.7140%	13,672,626
13	**TOTAL OPERATING EXPENSES**	102,153,328	0	(713,037)	(1,001,214)	(586,651)	(1,785,237)	(13,559,953)	84,507,236		69,417,085
	INCOME BEFORE TAXES	19,034,636	850,099	713,037	1,001,214	586,651	1,785,237	13,559,953	37,530,828		21,066,057
	OPERATING TAXES										
15	Operating Federal Income Tax	5,121,409	271,233	227,502	319,447	187,177	569,598	4,316,133	11,012,499		

16	Operating State Income Tax	1,967,377	75,149	63,032	88,507	51,860	157,815	1,117,340	3,521,081		
17	Taxes Other than on Income	1,915,841	0	0	0	0	0	0	1,915,841		
18	Provision for Def Op. Inc. Tax	342,898	0	0	0	0	0	$ 386,459	729,357		
19	**TOTAL OPERATING TAXES**	9,347,525	346,382	290,534	407,955	239,037	727,413	5,819,932	17,178,777	a /	13,368,520
20	**NET OPERATING INCOME**	9,687,111	503,717	422,503	593,259	347,614	1,057,824	7,740,021	20,352,051		7,697,537
	RATE BASE (Average)										
21	Tel. Plant in Service	392,165,678	0	0	0	0	0	0	392,165,678	79.5900%	312,124,663
22	Tel. Plant Under Const.	16,357,825	0	0	0	0	0	0	16,357,825	79.5900%	13,019,193
23	Materials & Supplies	1,282,039	0	0	0	0	0	0	1,282,039	74.3407%	953,076
24	Cash Working Capital	7,305,401	0	$ (82,306)	(115,571)	(67,718)	(206,071)	0	6,833,735	83.2903%	5,691,838
25	Depreciation Reserve	(190,591,628)	0	0	0	0	0	6,779,977	(183,811,652)	79.3601%	(145,873,110)
26	Deferred Tax	(15,474,619)	0	0	0	0	0	$ (193,230)	(15,667,848)	79.7666%	(12,497,710)
27	Customer Deposits	(181,408)	0	0	0	0	0	0	(181,408)	79.5900%	(144,383)
28	**TOTAL RATE BASE**	210,863,288	0	(82,306)	(115,571)	(67,718)	(206,071)	6,586,747	216,978,369		173,273,568
29	**RATE OF RETURN**								**9.38%**		**4.44%**

(END OF APPENDIX A)

APPENDIX B

SureWest Telephone Company
Composite Depreciation Rate of 5.85%
2002 Detailed Depreciation Represcription Rates

Description	Rate	Description	Rate
Motor Vehicles	3.38%	Circuit Equipment/Digital ADSL	25.42
Garage Work Equipment	9.64	Circuit Equipment/Digital–Optical	8.36
Other Work Equipment	7.48	Circuit Equipment/Analog	13.83
Buildings	2.55	Other Terminal Equipment	12.26
Furniture	7.77	Pole Line	6.14
Office Equipment/ Data	0.31	Poles/Joint	6.24
Office Equipment/Official CPE	0.00	Aerial Cable/Metallic	3.21
Office Equipment/Other	0.30	Aerial Cable/Fiber	5.14
General Purpose Computers	5.40	Aerial Cable/COAX	24.45
Digital Switch/STP COE (CAT 2)	7.65	Underground Cable/Metallic	1.94
Digital Switch/SureWest (CAT 2 & 3)	7.48	Underground Cable/Fiber	4.71
Digital Switch/Citrus Heights (CAT 3)	7.35	Underground Cable/COAX	22.31
Digital Switch/Data (CAT 3)	13.87	Buried Cable/Metallic	1.75
Voice Mail System	13.53	Buried Cable/Fiber	4.37
Operator Systems #5 ESS (CAT 2)	1.19	Buried Cable/COAX	20.50
Radio Systems/Analog	9.86	IntraBuilding Network Cable	12.65
Circuit Equipment/Analog (Other)	9.23	Aerial Wire	18.80
Circuit Equipment/Analog (LRS)	0.00	Conduit Systems	2.37
Circuit Equipment/Analog (ALM)	0.00	General Purpose Software	27.28
Circuit Equipment/Digital NonOptical	10.70	Network Software	28.03

(End of Appendix B)